

**Verification of Deferred Balances
And
Prudence Review
Phase 2: August 2002 – July 2003**

Rockland Electric Company

Volume 1 – Verification and Analysis

Redacted Version

*RECO Claimed “Trade Secret” Information
Has Been Redacted*

**PREPARED FOR
THE NEW JERSEY BOARD OF PUBLIC UTILITIES
BY**

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October 14, 2003

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Appendix I – Synapse Energy Economics Report on Phase 2 Prudence Review

Volume 2 – Exhibits

Exhibits showing verified monthly balances for RECO's deferrals and calculations of interest on corrected monthly deferred balances are presented in Volume 2 of this report.

I. Executive Summary

Chapter 1 – Executive Summary

A. Background

Rockland Electric Company (“RECO or Company”) is a wholly owned subsidiary of Orange & Rockland (“O&R”), which in turn is a wholly owned subsidiary of Consolidated Edison Company (“Con Edison”).

Prior to the Con Edison merger, O&R was an exempt holding company and the operating company serving a territory in New York. The other regulated utility companies besides O&R are RECO and Pike County Light and Power Company (“Pike”). RECO and Pike exist because of the state boundaries. RECO is in New Jersey and Pike is in Pennsylvania. RECO and Pike have no employees. All services are provided by O&R.

O&R, RECO and Pike function as an integrated system. The system was part of the New York Power Pool (“NYPP”). O&R operates the system as one integrated system. The NYPP became the New York Independent System Operator (“NYISO”) and, as a result, O&R became affiliated with the NYISO.

O&R generation and NYPP economic purchases provided for the power supply needs of the entire O&R system. Through a FERC-approved Power Supply Agreement (“PSA”), the costs associated with the O&R system power supply were allocated to RECO.

O&R sold all of its generation assets to affiliates of Southern Company. All of the generation assets formerly owned by O&R are located in New York. O&R received approval from all three states (NY, NJ and PA) for the sale of the O&R generation assets. O&R’s belief was that New York had sole jurisdiction over the sale of the plants, but O&R nevertheless sought and received approval not only from New York, but also from New Jersey and Pennsylvania.

O&R entered into buy-back contracts for the power from the units it sold to Southern. As those contracts were phased out, O&R power purchases were conducted through the NYISO.

Within the O&R system, there are three operating divisions:

- 1) Eastern, consisting of O&R and RECO, which services Rockland County, New York and the northern part of Bergen County, New Jersey.
- 2) Central, consisting of O&R and RECO, which services portions of Sussex and Passiac Counties, New Jersey (RECO), and Orange & Rockland Counties, New York (O&R).

- 3) Western, consisting of O&R, RECO and Pike, which services part of Pike County in Pennsylvania, Sullivan County, New York (O&R), and Sussex County, New Jersey (RECO).

Retail access for the entire O&R region was made available in 1999. Retail access for the New York and Pennsylvania portions occurred in May 1999 and for the New Jersey (RECO) portion in August 1999.

As part of the NJ electric utility industry restructuring, and in accordance with the Electric Discount and Energy Competition Act (N.J.S.A. 48:3-49 et seq., “EDECA”), RECO’s rates were unbundled, reduced and frozen for a four-year transition period, from August 1, 1999 through July 31, 2003. During this period, RECO accumulated the differences between the revenues it received for Basic Generation Service (“BGS”), Energy Cost Adjustment (“ECA”), and Societal Benefits Charge (“SBC”) and related costs in deferral accounts. RECO’s August 30, 2002 filing in Exhibits FPM-2, FPM-3 and FPM-4 presented monthly balances for BGS, ECA and SBC deferrals respectively. The information presented on these RECO exhibits contained actual amounts for August 1999 through July 2002, and projected amounts for August 2002 through July 2003. Subsequently, the exhibits referenced above have been updated and are now referred to as Exhibits, RM-2, RM-3 and RM-4. These updated exhibits now contain actual amounts for the period August 2002 through July 2003.

The New Jersey Board of Public Utilities (“Board” or “BPU”) hired Larkin & Associates, PLLC (“L&A”) to review and verify RECO’s BGS, ECA and SBC deferrals. The review is being conducted in two phases. Phase I covered the three-year period August 1999 through July 2002. Phase II covers the period August 2002 through July 2003. The review conducted by L&A also included a review of RECO’s interest calculation, which initially was presented on RECO Exhibit FPM-8 (now Exhibit RM-8) and verification of RECO’s deferred restructuring proceeding costs, which were initially presented by the Company on RECO Exhibit FPM-9 (now Exhibit RM-9).

B. Organization of Report

This report is organized into two volumes. Volume 1 describes the review of each area, and presents the analysis and conclusions. Volume 2 presents exhibits relating to the verification of RECO’s deferred balances and the calculation of interest. The exhibits presented in Volume 2 are referenced in Volume 1.

Volume 1 is organized into the following three major sections:

- I. Executive Summary (Chapter 1)
- II. Verification of Deferred Balances (Chapters 2-5)
- III. Interest Calculation (Chapter 6)

Within Section II, Verification of Deferred Balances, the presentation is organized into the following chapters:

2. Verification of BGS deferrals

3. Verification of ECA deferrals
4. Verification of SBC deferrals
5. Verification of Restructuring Proceeding Cost Deferrals

Section III, Interest Calculation, consists of Chapter 6. The interest calculation uses the BGS, ECA, SBC and deferred restructuring proceeding balances from Chapters 2 through 5, respectively. This chapter also addresses disallowances ordered by the Board in their Summary Order dated 7/31/03 with respect to the Phase I portion of this review.

The review of prudence for Phase 2 was performed by Synapse Energy-Economics, Inc. ("Synapse"). The Synapse Phase 2 report was completed on May 30, 2003, and is attached to this report as Appendix I.

C. Review Periods

This report is for Phase II. The review period covered in this report is August 1, 2002 through July 31, 2003. This represents Year 4 of the transition period for RECO in conjunction with the NJ electric utility industry restructuring. Review of RECO's deferred balances for Years 1 through 3, which covered the period August 1, 1999 through July 31, 2002, was addressed in Phase I. As part of the Phase II review, we reviewed RECO's calculation of adjustments ordered by the Board in Phase I. This included a review of RECO's re-calculation of interest for the Phase I period, including adjustments.

D. Review Standards and Procedures

Larkin & Associates' review process ensures that work is factually based, that the observations and comments formed are supported by relevant data, that professional judgment, where applied, is differentiated from analytical results, and that the results of the review are traceable to specific efforts.

During Phase II of this project, L&A conducted one formal interview with Company personnel. A summary of this interview was prepared and provided to the Company. The summary was reviewed, edited if necessary, signed by the interviewees and returned to L&A. L&A also conducted several informal discussions with RECO, Orange and Rockland (O&R), and Con Edison personnel.

During Phase II of this project, L&A also issued nine sets of Audit Data Requests (ADRs), RECO-ADR-L-113 through RECO-ADR-L-178. The majority of our review during Phase II was conducted in L&A's offices in Livonia, Michigan. In order to facilitate quick responses to our inquiries, seven of the nine sets of ADRs were communicated to Company personnel in an informal fashion. The responses to the ADRs were then reviewed and analyzed.

In addition to the formal interview and ADRs, deferred balance verification and reconciliation issues were addressed through informal discussions with Con Edison

accounting personnel, with accompanying exchange of information. The project team appreciates the assistance of Con Edison and O&R personnel in resolving deferred balance reconciliation issues.

The parties involved in L&A's quality assurance process for this review were L&A consultants. Our approach to project management and preparing this review are essential components of L&A's quality assurance process. No pertinent information was omitted from this report because it was deemed privileged or confidential.

E. Summary of Findings and Conclusions

As shown in Exhibits 2.1, 3.1 and 4.1, provided in Volume 2 of this report, the verified amounts of RECO's deferred BGS, ECA, and SBC balances at July 31, 2003, including the impacts of corrections that were identified during the verification process, and accounting for the amounts disallowed by the Board with respect to the BGS deferred balance are \$75.869 million, \$8.806 million (credit balance), and \$2.381 million, respectively. These Exhibits also show the amounts for each month during the Phase II review period of August 2002 through July 2003.

Exhibit 5.1, in Volume 2 of this report, summarizes the verified amounts for RECO's restructuring proceeding cost deferrals of \$1.591 million after reflecting the verified restructuring proceeding balance at the conclusion of Phase I and adding the additional costs incurred during Phase II. The balance as of July 31, 2003 was \$1.511 million.

The following table summarizes the results of our Phase II verification:

Summary of Verified Deferred Balances and Adjustments

Line	Description	BGS	ECA	SBC	RPC
1	RECO Deferred Balances	\$ 92,419	\$ (8,804)	\$ 2,413	\$ 1,511
2	Board Adjustments	\$ (16,540)			
3	L&A Verification Adjustments	\$ (10)	\$ (2)	\$ (32)	
4	Adjusted Deferred Balances	\$ 75,869	\$ (8,806)	\$ 2,381	\$ 1,511
5	Exhibit Reference for Verified	Exhibit 2.1	Exhibit 3.1	Exhibit 4.1	Exhibit 5.1
	7/31/03 Deferred Balance	Page 4	Page 4	Page 4	Page 1

Exhibit 6.1 presents a calculation of interest that is done on a "net of tax" basis for the period August 2002 through July 31, 2003 on the corrected monthly deferred balances and accounting for the amounts disallowed by the Board with respect to the Phase I BGS deferred balance. This calculation results in interest of \$6.894 million on the corrected RECO deferred balances through July 31, 2003.

Exhibit 6.2 presents an interest calculation which incorporates the impact of removing the amounts disallowed by the Board with respect to labor and overhead costs associated with the transfer of RECO's Eastern Division to PJM and the Year 4 BGS auction, by prorating the removal of such costs in the months they were incurred (August 2001 through July 2002). These calculations result in interest of \$6.882 million through July 31, 2003 on the deferred balances.

As described in Appendix I (the Synapse Phase II report concerning prudence), Synapse reviewed documents related to the Year 4 BGS Auction and RECO's participation in that auction. Synapse also spoke to BPU Staff concerning the auction process. In conclusion, Synapse has not seen any evidence that unreasonable actions by RECO increased the ultimate price the Company is paying for power for BGS customers during the period August 1, 2002 through July 31, 2003.

II. Verification of Deferred Balances-Phase II

Chapter 2 – Verification of BGS Deferrals

Overview

In RECO Exhibit FPM-2 and subsequently Exhibit RM-2, the Company reports the following amounts of Basic Generation Service Costs, Revenues, and Deferred Fuel Amortization for the period August 2002 through July 2003. It should be noted that at the start of Phase II, RECO provided us with an updated version of Exhibit FPM-2 dated 12/31/02, showing actual data from August through November 2002. RECO subsequently provided a further updated version of BGS costs and revenues in Exhibit RM-2 dated 7/3/03, showing actual data through 5/31/03. RECO then provided a final updated version of Exhibit RM-2 on 8/28/03, showing actual data through 7/31/03. Throughout this report, Exhibit RM-2 will be referenced, as it is the most current version.

Rockland Electric Company Basic Generation Service Summary of Year 4 (\$000's)	Actual 12 Months Ended 7/31/03
Period Costs and Revenues	
BGS Auction / PJM Transfer	\$ 28
Purchased Power Costs - NYISO	\$ 10,081
Purchased Power Costs - PJM	\$ 70,419
Eastern Load Pocket Costs	\$ 367
Hedging Costs	\$ 300
Total BGS Costs	\$ 81,195
BGS Revenue	\$ (68,118)
Deferred Fuel Amortization	\$ (137)
Deferred Balances	
Beginning Balance	\$ 79,479
Ending Balance	\$ 92,419

The total BGS costs in the above table include “at market” NUG power purchase costs of \$16.923 million.

Verification Process

Verification efforts related to RECO’s deferred BGS costs included:

- Verifying purchased power invoices to O&R’s Detailed Trial Balance for Purchased Power.
- Verifying amounts on the O&R MSC¹ workpapers to invoices.
- Reconciling amounts on RECO Exhibit RM-2 to the O&R MSC workpapers.

¹ The term “MSC” is derived from “Market Supply Charge” which is a term used in New York.

- Where invoices were from Con Edison to O&R, obtaining and reviewing power cost charges to Con Edison from third-party suppliers.
- Testing calculations on the O&R MSC workpapers.
- Conducted an interview with Con Edison personnel concerning power costs charged to RECO.
- Review of hedging cost invoices and allocations of such costs to RECO.
- Obtaining and reviewing monthly amounts from RECO's Balance Sheet & Expense Detail Trial Balance for the period August 2002 through July 2003.
- Tracing amounts on Exhibit RM-2 to RECO's Balance Sheet & Expense Detail Trial Balance.
- Investigating variances in each month that were noted. This was done by presenting a series of informal data requests and/or schedules showing the variances to Con Edison personnel, and obtaining explanations and further reconciliation detail from them.

Additional details concerning verification efforts related to specific costs affecting RECO's deferred BGS balance and verification of monthly BGS revenues (net of NJ sales tax) are described below. These specific costs will be discussed in the same order that they are presented on Exhibit RM-2.

Verification of PJM Transfer/BGS Auction Costs

For Phase II, RECO Exhibit RM-2 included \$28,000 of costs from August 2002 through July 31, 2003 related to the transfer of RECO's Eastern Division to PJM and the BGS Year 4 auction.

Verification efforts for this cost included:

- Obtaining copies of RECO's work orders used to accumulate such costs.
- Obtaining invoices for the costs and tracing the amounts RECO accumulated in the applicable work orders to the invoices.
- Tracing the amounts RECO accumulated in the applicable work orders to their Balance Sheet & Expense Detail Trial Balance.
- Preparing a workpaper that reconciled the amounts accumulated in RECO work orders 40-8848, 46-8848 and 46-8964 to Exhibit RM-2.
- Resolving reconciling differences through a number of informal data requests to Con Edison accounting personnel who provided explanations and supporting documentation that upon our analysis, enabled us to satisfactorily resolve the outstanding issues.
- Making adjustments for the removal of labor and overhead costs that were disallowed by the Board in their Summary Order dated 7/31/03. (See additional discussion below).
- Recalculating the amount of charges recorded in each month and comparing these with the amounts listed on Exhibit RM-2.

In accordance with the Board's Summary Order dated 7/31/03, approximately \$325,000 of labor and overhead costs related to the transfer of RECO's Eastern Division to PJM and the Year 4 BGS auction for the period August 2001 through July 2002 have been disallowed and thus removed. For the period August 2002 through July 2003, RECO

included approximately \$8,000 of additional labor and overhead costs that were similar in nature to the \$325,000 disallowed by the Board in Phase I. To be consistent with that Phase I disallowance, the \$8,000 of labor and overhead costs for the period August 2002 through July 2003, have been removed. The adjustment to remove the \$8,000 appear on Exhibit 2.1.

After reflecting the removal of \$8,000 of labor and overhead cost, based on the verification conducted, we are satisfied that the costs related to the transfer of RECO's Eastern Division to PJM and the BGS Year 4 auction on RECO Exhibit RM-2 from August 2002 through July 2003, are adequately supported by invoices and related accounting documentation

Verification of Purchased Power Costs

To verify RECO's purchased power costs from the NYISO and PJM, we obtained and reviewed the Company's calculations contained in the MSC workpapers. From the MSC workpapers, we traced the amounts that are presented on RECO Exhibit RM-2. From August 2002 through July 2003, minor variances with the NYISO purchased power costs were noted and investigated. Through our analysis, we concluded most of the variances were rounding issues and one was the result of an adjustment made by RECO that was not reflected on Exhibit RM-2.

We verified purchased power costs to invoices by summarizing the monthly power purchases from the Detailed Trial Balance for Purchased Power onto a workpaper that summarized the monthly power purchases from the Detail Trial Balance for Purchased Power for the period August 2002 through July 2003. We then compared each month's amount with the amounts shown on RECO's supporting documentation and Monthly Purchases/Sales kWh and Associated Costs worksheets. Where issues arose concerning certain amounts during the verification process, these were discussed with Company personnel and were satisfactorily resolved.

There were a number of invoices billed to O&R from Con Edison for power and/or hedging purchases made by Con Edison on O&R's behalf. We obtained and reviewed invoices showing power cost charges to Con Edison from third-party suppliers.

Verification of Load Pocket Costs

RECO's Eastern Division exists in a load pocket. At times, due to transmission constraints, the Lovett Plant that O&R sold to Southern Company affiliates must be run to provide energy to RECO's Eastern Division. O&R has an Eastern Load Pocket Agreement with Mirant² to ensure the availability of the Lovett generating station which is located in the Eastern Load Pocket. Under this agreement, an annual payment is made to Mirant to ensure the availability of Lovett, subject to minimum availability criteria. The Agreement also requires that additional payments be made to Mirant in those instances when the system's operators require Lovett to operate to ensure load pocket reliability, but the NYISO has not dispatched Lovett to a sufficient level to support the load pocket, due to economic considerations. To verify RECO's Eastern Load Pocket

² Formerly Southern Energy affiliates.

Costs, we obtained and reviewed the Company's Substation Output Summaries and other supporting documentation provided, tested the calculations, and traced these amounts to RECO's Balance Sheet & Expense Detail Trial Balance. We then compared the amounts verified in the Balance Sheet & Expense Detail Trial Balance to RECO Exhibit RM-2.

In addition, on the reconciling workpaper referenced above, a few questions arose concerning the timing and amounts of Load Pocket payments. These issues were discussed with Con Edison accounting personnel. Due to the difficulty Con Edison has with verifying power usage related to generation for load pocket issues, amounts for load pocket power purchases are often accrued over several months, and are then paid in a lump sum upon verification. Based on the follow through discussions and documentation provided, we are satisfied that the load pocket costs reflected on RECO Exhibit RM-2 are supported by documentation and invoices.

Verification of Hedging Cost

RECO Exhibit RM-2 included \$300,000 of hedging costs from August 2002 through July 2003. All energy price hedging contracts for O&R and RECO were obtained on their behalf by the Con Edison Supply Department.

Verification efforts for hedging costs charged to RECO included:

- Verifying the amounts for hedging cost on RECO Exhibit RM-2 to the monthly O&R MSC workpapers.
- Conducting an interview with Con Edison Supply Department personnel to understand the specific hedging transactions entered into on behalf of O&R and RECO during Phase II.
- Verifying amounts for hedging costs shown on the monthly O&R MSC workpapers to invoices.
- Checking the allocation of hedging cost to RECO by reviewing and recalculating allocations prepared by the Con Edison Supply Department.
- Reviewing billings from Con Edison to O&R and RECO for hedging costs.
- Obtaining explanations from Con Edison for variances noted.
- Following through with Con Edison to obtain missing information.

Based on the verification conducted, we conclude that the cost of hedging contracts entered into by the Con Edison Supply Department on behalf of O&R and RECO is adequately documented with invoices, and the allocations of hedging cost to RECO were based on rational relationships between the cost incurred and the purpose of the hedging transaction.

Verification of BGS Revenue

To verify monthly BGS revenue, we obtained copies of RECO's monthly revenue reports and compiled the monthly BGS revenues from such reports for the period August 2002 through July 2003. We then verified that RECO removed the NJ sales tax (by dividing the monthly revenue amounts by 1.06) and compared the results with the monthly BGS revenues listed on RECO Exhibit RM-2. No variances were noted and therefore, based

on the verification conducted, we are satisfied that the amounts for BGS revenue on RECO Exhibit RM-2 are accurately reflected.

Verification of Deferred Fuel Amortization

RECO Exhibit RM-2 shows approximately \$137,000 of Deferred Fuel Amortization for the period August 2002 through July 2003. The monthly amounts on Exhibit RM-2 were compared with the amounts listed on a Company provided workpaper, which is a continuation of the schedule RECO provided in their response to RECO-ADR-L-20 during Phase I. After testing the calculations, a couple of minor variances due to rounding differences were noted but were immaterial. Based on the verification conducted, we are satisfied that the amounts for the Deferred Fuel Amortization amount on RECO Exhibit RM-2 are appropriate.

Correction to Beginning Balance on RECO Exhibit RM-2

In accordance with the Board's Summary Order dated 7/31/03, in addition to the \$325,000 of labor and overhead cost related to the transfer of RECO's Eastern Division to PJM and BGS Year 4 auction referenced above, the amount of \$14 million, which reflects a disallowance of \$8.2 million for the Company's failure to extend the energy component of its parting contract with Southern Energy Affiliates (now Mirant) through the months of May, June, July and August 2000, as well as one-half, or \$5.8 million, of hedging costs incurred by the Company during the four-year transition period. Furthermore, the Board ordered that an additional \$2.2 million, which reflects increased costs attributed to a six-month delay in RECO's joining PJM, be disallowed as well. The net effect of these adjustments has reduced RECO's beginning BGS balance for the period August 2002 through July 2003, to \$62.958 million. It should be noted that based upon the methodology used to remove the hedging costs that were disallowed per the Board's ruling, one-half of the hedging costs, or \$19,000, was removed during the Phase II period of August 1, 2002 through July 31, 2003. The \$19,000 of hedging costs was removed over the period of August through October 2002 based on the months in which such costs were recorded by RECO.

Summary

Exhibit 2.1 in Volume 2 of this report, shows the monthly verified amounts for RECO's BGS deferrals, after reflecting the corrections discovered by L&A during the verification process as well as accounting for the amounts disallowed by the Board in their Summary Order dated 7/31/03. As shown on Exhibit 2.1, the corrected deferred BGS balance at July 31, 2003, is \$75.869 million.

Chapter 3 – Verification of ECA Deferrals

Overview

The monthly ECA deferrals are the result of the difference between (1) monthly ECA revenues and (2) monthly ECA costs. The monthly ECA costs are the above-market cost of power purchases from Non-Utility Generators (NUGs). During the period August 2002 through July 2003, RECO reported on Exhibit FPM-3 and subsequently Exhibit RM-3, amounts of \$1.650 million of above-market NUG costs and \$761,000 of ECA revenue, resulting in a net credit of \$8.804 million for its deferred ECA balance at July 31, 2003. It should be noted that at the start of Phase II, RECO provided us with an updated version of Exhibit FPM-3 dated 12/31/02, showing actual data from August through November 2002. RECO subsequently provided a further updated version of ECA costs and revenues in Exhibit RM-3 dated 7/3/03, showing actual data through 5/31/03. RECO then provided a final updated version of Exhibit RM-3 on 9/3/03, showing actual data through 7/31/03. Throughout this report, Exhibit RM-3 will be referenced, as it is the most current version.

RECO's parent company, Orange and Rockland, has five NUG contracts. The cost of power purchased under the O&R contracts with the NUGs is allocated pursuant to the O&R Power Supply Agreement ("PSA"). The O&R PSA describes how power purchased by O&R is allocated among the O&R companies, which include Orange & Rockland (New York), Pike County Light and Power Company (Pennsylvania) and RECO (New Jersey). Prior to the transfer of RECO's Eastern Division to PJM, the above-market cost of all O&R NUGs was determined by comparing the cost of power purchased from the NUGs with the average cost of NYISO power for the month. After the transfer of RECO's Eastern Division to PJM, two calculations are made: one for the NUGs located in the NYISO, and another calculation for the one NUG that is now located within the PJM boundary.

Verification Approach

Our verification of RECO's monthly ECA deferrals included the following:

- We obtained monthly amounts from RECO's Balance Sheet & Expense Detail Trial Balance for the period August 2002 through July 2003.
- We summarized the monthly ECA deferrals from the Balance Sheet & Expense Detail Trial Balance on a workpaper and compared each month's amount with the amount shown on RECO Exhibit RM-3.
- Variances in some months were noted and investigated. Where appropriate, additional documentation was obtained by RECO and reviewed.
- The monthly calculations of above-market NUG costs were obtained and reviewed (See additional discussion below).
- Monthly ECA revenues on Exhibit RM-3 were reconciled with amounts obtained from RECO's monthly revenue reports. (See additional discussion below).

Verification of Above-Market NUG Cost

To verify RECO's above-market NUG costs, we obtained and reviewed the Company's calculations.³ The review of above-market NUG costs, which are allocated to ECA, was conducted as part of our overall review of O&R NUG costs allocated to RECO. NUG costs were verified to invoices and the determination of above-market and at-market costs as calculated by the Company in its MSC workpapers were reviewed.

Effective March 1, 2002, RECO's Eastern Division became part of the PJM ISO. Prior to the effective date of this transfer, all of O&R, including RECO's Eastern Division had been in the NYISO. This change also effectively moved the border between PJM and the NYISO to the NJ-NY state line, whereas prior to the conversion, the NYISO extended into a portion of NJ served by RECO's Eastern Division. The conversion to PJM also affected how the above-market costs for one of the NUGs supplying power to O&R is calculated. Before the transfer of RECO's Eastern Division to PJM, all of the prices were utilized to determine the at-market and above-market costs. After RECO joined PJM, one of the O&R NUGs (Crossroads), which is in Mahwah, NJ, is now located in the PJM area. For this NUG that is now located in the PJM area, the Company uses PJM prices (rather than NYISO prices) to determine the at-market and above-market costs.

An average monthly price for each control area (NYISO and PJM) is used to determine the at-market NUG costs. The at-market NUG cost is included as part of the cost of serving BGS and is then deducted from the total net NUG cost for each control area, resulting in an amount of above-market NUG cost for each control area. The above-market NUG costs for each control area are added together and the total is allocated to O&R (NY), RECO (NJ) and Pike (PA) using system energy ratios.

During our verification process, some minor variances between the ECA costs we verified and the amounts shown on RECO Exhibit RM-3 were noted and investigated. Through our analysis, we concluded that the variances were the result of rounding issues.

We reviewed the Company's calculations of at-market and above-market NUG costs and the allocation to RECO for the period August 2002 through July 2003 and found them to be reasonable.

Verification of ECA Revenue

To verify monthly ECA revenue, we obtained copies of RECO's monthly revenue reports and compiled the monthly ECA revenues from such reports. We then verified that RECO removed the NJ sales tax (by dividing the monthly revenue amounts by 1.06) and compared the results with the monthly ECA revenues listed on RECO Exhibit RM-3. Some minor variances were noted and investigated. Through our analysis, we concluded that the variances resulted from rounding differences.

³ The at-market and above-market NUG cost calculations are part of the monthly MSC workpapers which show the allocation of purchased power cost between O&R (NY), RECO (NJ) and Pike (PA).

Correction to Beginning Balance on RECO Exhibit RM-3

Upon receiving RECO's Exhibit RM-3, we noted that the beginning balance reflected an additional credit of \$27,000 resulting in a beginning credit balance of \$9.693 million (originally \$9.666 million). In response to an informal data request, RECO explained that the \$27,000 was an adjustment to ECA revenue for the month ended 12/31/00. RECO provided supporting documentation for this adjustment and we are satisfied with their explanation.

Summary

Exhibit 3.1, in Volume 2 of this report, shows the monthly verified amounts for RECO's ECA deferrals after reflecting the corrections discovered by L&A during the verification process. As shown on Exhibit 3.1, the corrected deferred ECA balance at July 31, 2003, is a credit balance of \$8.806 million.

Chapter 4 – Verification of SBC Deferrals

Overview

As shown on RECO Exhibit RM-4, for the period August 2002 through July 2003, the Company incurred costs for the Societal Benefit Charge (SBC) in three categories:

Energy Efficiency & Renewables (“EE&R”),
Consumer Education Program (“CEP”), and
Universal Service Fund (“USF”).

In May 2003, RECO added an additional item to its deferred SBC for “Lost Revenues.”

Monthly SBC revenues are compared with monthly SBC costs, and the difference is recorded as an adjustment to RECO’s deferred SBC balance.

Verification of EE&R Costs

RECO Exhibit FPM-4 and subsequently Exhibit RM-4 includes \$1.793 million of cost for EE&R program costs in individual work orders to keep track of the costs it is incurring for specific programs. Charges are cleared on a monthly basis from the work orders and posted to the deferral account.

It should be noted that at the start of Phase II, RECO provided us with an updated version of Exhibit FPM-4 dated 12/31/02, showing actual data from August through November 2002. RECO subsequently provided a further updated version of SBC costs and revenues in Exhibit RM-4 dated 7/3/03, showing actual data through 5/31/03. RECO then provided a final updated version of Exhibit RM-4 on 9/3/03, showing actual data through 7/31/03. Throughout this report, Exhibit RM-4 will be referenced, as it is the most current version.

Our verification of RECO’s deferred EE&R costs consisted of multiple steps, including the following:

- Obtaining a listing of work orders and costs for each work order.
- Tracing O&R’s and RECO’s invoices to the individual work orders.
- Tracing costs in the EE&R work orders, which are designated by specific numbers, to the RECO Balance Sheet & Expense Detail Trial Balance (General Ledger).
- Tracing the amounts from the Balance Sheet & Expense Detail Trial Balance that cleared the costs recorded in the work orders by transferring such costs into the deferral account. This was accomplished by tying the amounts clearing the work orders to the General Ledger. In some of the work orders, due to accruals carrying over from month to month, the amounts that cleared the work orders did not always agree with the Accounts Payable distributions. Through our analysis, we determined by journal entry number, which amounts represented Accounts Payable distributions

and which amounts represented accruals. The netting of these amounts agreed with the amounts clearing the work orders and postings to the General Ledger.

- Analyzing the RECO provided Compilation of Supporting Documentation worksheet, which provided a breakout of the EE&R costs from RECO Exhibit RM-4. Through a series of computations, we were able to trace most of the amounts from the Compilation of Supporting Documentation worksheet to the General Ledger. Through additional analysis, we were able to satisfactorily resolve the remaining issues.
- Comparing the amounts on RECO Exhibit RM-4 to the General Ledger. This revealed minor variances in a couple of months. Through our analysis, we determined the variances to be the result of rounding differences.

For the month ended 5/31/03, RECO included with their EE&R costs, Lost Revenues for the years ended 2000, 2001 and 2002 totaling \$434,000. As part of our initial analysis, we traced the amount noted above to RECO's Balance Sheet & Expense Detail Trial Balance (General Ledger). However, as promulgated by the Board in their Summary Order dated 7/28/99, page 4, paragraph 17, recovering Generation related lost revenues through the SBC deferred balance is disallowed effective August 1, 1999. In response to an informal data request regarding this matter, RECO stated that the lost revenues included on Exhibit RM-4 were related to Transmission and Distribution, not Generation, and supporting documentation was provided. Our analysis of the supporting documentation included detailed testing of RECO's calculations for the month of December 2001. As a result of this detailed testing, a significant discrepancy regarding lost kWh used in RECO's calculation of lost revenues was noted and investigated. After issuance of additional informal data requests and a discussion with Company personnel, RECO agreed to a correction of errors noted by agreeing to remove approximately \$31,000 from its lost revenue calculation. After correcting for the noted errors by removing the \$31,000, we conclude that the lost revenues included on RECO Exhibit RM-4 are Transmission and Distribution related and that the amounts are supported by the underlying documentation.

Our verification efforts for EE&R costs for this period resulted in a recommended correction to the Company's amount shown on RECO Exhibit RM-4 for the month ended May 2003, which reduces RECO's amount by \$31,000. After making that correction to RECO's Lost Revenues amount, we conclude that RECO's EE&R costs for the period August 2002 through July 2003, are adequately supported by accounting records and invoices.

RECO indicated that, prior to its recording an entry in May 2003, it inadvertently overlooked the Lost Revenues for 2000, 2001 and 2002. There may be an issue for the Board to address concerning whether there is any impact on the recoverability of RECO's adjusted Lost Revenues amount related to RECO's delay in requesting this item for recovery.

Verification of CEP Costs

The CEP is part of the original NJ regulatory proceeding that called for educating NJ customers (both electric and gas) that they have opportunities to select other suppliers of the commodity. Customers were also educated and informed that their electric service bills would look different. There would be a separate charge for the commodity. Customers were informed that they could select an alternative supplier or stay with the utility. RECO's CEP included two components:

- 1) a statewide integrated program to educate customers about the changes and the choices they would have; and
- 2) a localized RECO-specific program to supplement the statewide program and address specifics that applied to the RECO service area.

All of the costs for CEP, totaling approximately \$12,000 from August 2002 through July 2003, on RECO Exhibit RM-4, are costs associated with Winning Strategies in conjunction with Year 4 Public Relations Services, and New Jersey Citizen Action (NJCA). Per their agreement with the Utility Education Committee for Outreach Services, NJCA provided statewide presentations and related outreach services for the New Jersey Energy Choice Community Education Program. The amounts charged to RECO represents RECO's portion of NJCA's monthly fee for their services.

To verify RECO's CEP costs, the monthly amounts listed on Exhibit RM-4 were traced to RECO's Balance Sheet & Expense Detail Trial Balance (General Ledger), and invoices for such costs were reviewed. We noted that for the month ended August 2002, RECO Exhibit RM-4 shows \$1,000 of CEP related costs. However, no invoices were provided to verify that amount. Furthermore, upon reviewing RECO's General Ledger, no activity is indicated for the month ended August 2002. In response to an informal data request, RECO concurred that there is no basis for this amount.

For the month ended 12/31/02, RECO's General Ledger included a posting in the amount of \$18,855. In response to an informal data request, RECO confirmed that the \$18,855 represented CEP costs initially expensed when incurred in 1999 that RECO was now including in the deferred SBC balance (See additional discussion below).

We conclude that RECO's CEP costs for the period August 2002 through July 2003 are adequately supported by accounting records and invoices. Our verification efforts for CEP costs for this period resulted in a minor correction to the Company's amount shown on RECO Exhibit RM-4 for the month ended August 2002.

Verification of USF

The Universal Service Fund (USF) is a low income program. All NJ utilities were ordered to implement an interim USF for the 2001/2002 heating season. A Board order concerning this issue was issued in Docket No. EX00020091 in April 2002. There was an additional Board order issued November 21, 2001, setting up the program. The final order requires that any electric heating and LIHEAP eligible customer receives a \$200

bill credit. This is a statewide program for all NJ electric utilities. There were only 28 customers in the RECO service territory which received USF payments from the interim program. RECO incurred administrative costs in 2002, including payroll cost and travel expense to attend meetings with the BPU Staff that was related to both the interim and permanent USF programs.

RECO's Exhibit RM-4 shows approximately \$13,000 of Universal Service Fund cost from August 2002 through July 2003. To verify RECO's USF costs, the monthly amounts listed on Exhibit RM-4 were traced to RECO's work order that from August through December 2002 had the heading, "Conservation Programs by Cost Area". From January through July 2003, the work order had the heading, "Work in Progress Detail Trial Balance". The work orders were then traced to RECO's Balance Sheet & Expense Detail Trial Balance (General Ledger). One minor variance was noted that we determined was the result of a rounding difference.

Verification of SBC Revenue

To verify monthly SBC revenue, we obtained copies of RECO's monthly revenue reports and compiled the monthly SBC revenues from such reports. We then verified that RECO removed the NJ sales tax (by dividing the monthly revenue amounts by 1.06) and compared the amounts with the monthly SBC revenues listed on RECO Exhibit RM-4. In accordance with RECO's restructuring plan, a zero SBC charge was billed in year four of the transition period in order to achieve RECO's EDECA-mandated rate reduction in that year. Accordingly, the only months that RECO had measurable SBC revenue were August and September 2002. Variances were noted in both months. Through our analysis, we determined that a reduction of SBC revenue in the amount of \$1,889 indicated on RECO's monthly revenue report for August 2002 was not reflected on Exhibit RM-4. A variance noted in September 2002 was the result of a rounding difference.

Our initial review of RECO's monthly revenue reports indicated SBC revenues in the amounts of \$34,000 and \$48,000 (net of NJ sales tax) for November 2002 and February 2003 respectively. However, those same months on RECO Exhibit RM-4 indicated zero revenue. In response to an informal data request, RECO explained that the amounts were delivery charges booked to SBC revenue in error. RECO provided us with revised versions of the relevant monthly revenue reports with those amounts removed.

Adjustments to Beginning Balance on RECO Exhibit RM-4

Upon reviewing RECO's updated Exhibit RM-4, we noted that the Phase II SBC beginning balance had been adjusted. Upon a more thorough review, we noted that approximately \$19,000 of CEP costs had been allocated to the months of September, October and December 1999 on Exhibit RM-4. In response to an informal data request, RECO confirmed that the \$19,000 represented the CEP costs referenced above that RECO initially expensed in 1999, that it has now included in the SBC deferred balance. Supporting invoices for these costs were provided and reviewed.

In addition, we noted several adjustments to EE&R costs covering the period of May through September 2001 totaling \$15,000. In response to another informal data request, RECO provided an explanation and supporting documentation for the adjustments totaling \$15,000. The net effect of adding both the CEP costs totaling \$19,000 and the EE&R cost adjustments totaling \$15,000 to RECO Exhibit RM-4, resulted in an adjusted beginning deferred SBC balance of \$794,000 for Phase II.

Summary

Exhibit 4.1, in Volume 2 of this report, shows the monthly verified amounts for RECO's SBC deferrals, after reflecting the corrections discovered by L&A during the verification process. As shown on Exhibit 4.1, the corrected deferred SBC balance for RECO at July 31, 2003, is \$2.381 million.

Chapter 5 – Verification of Restructuring Proceeding Cost Deferrals

Overview

RECO Exhibit FPM-9 and subsequently Exhibit RM-9 shows additional restructuring proceeding costs incurred since the conclusion of Phase I (August 1999 through July 2002) of approximately \$419,000 for the period August 2002 through July 2003.

It should be noted that at the start of Phase II, RECO provided us with an updated version of Exhibit FPM-9 dated 12/31/02, and then Exhibit RM-9 dated 7/3/03, which presented the verified aggregate amount of restructuring proceeding costs at the conclusion of Phase I and the projected amount of restructuring proceeding costs that would be incurred for the period August 2002 through July 2003. RECO subsequently provided a final updated version of Exhibit RM-9 on 9/3/03, which included the actual data for the period August 2002 through July 2003. Our discussion of RECO's deferred restructuring proceeding costs references Exhibit RM-9, as it is the most current version of RECO's claim for such costs.

Verification Process

The verification process applied to test RECO's costs for the restructuring proceeding listed on RECO Exhibit RM-9 included the following:

- Obtaining and reviewing copies of invoices related to the restructuring proceeding
- Obtaining and reviewing copies of the RECO work orders (46-8973 and 46-9237) that pertained to the restructuring proceeding.
- Tracing amounts listed on the work orders to the invoices.
- Tracing amounts from the work orders to RECO's Balance Sheet & Expense Detail Trial Balance (General Ledger).
- Preparing a workpaper, which provided a breakout of the new restructuring proceeding costs RECO projected for the period August 2002 through July 2003 on Exhibit RM-9.
- Preparing an additional workpaper that reconciled RECO projected new restructuring proceeding costs for the period August 2002 through July 2003 to actual verified costs.

Summary

Exhibit 5.1, in Volume 2 of this report, summarizes the verified amounts for RECO's Phase II restructuring proceeding cost deferrals of approximately \$419,000. Combined with the verified amounts totaling \$1.136 million as of 7/31/02, and after reflecting the amortization amount of \$43,512, this produces a net total of \$1.511 million at 7/31/03.

In addition, there are Larkin & Associates and Liberty Consulting Group invoices totaling approximately \$80,000 related to RECO's restructuring proceeding that were unpaid as of 7/31/03. By adding that amount to the total noted above, RECO's total restructuring costs were \$1.591 million at 7/31/03. However, since those invoices were

unpaid at 7/31/03, the additional costs of \$80,000 are not reflected in the interest calculation, which is addressed in Chapter 6, below.

III. Interest Calculation

Chapter 6 – Interest Calculation

This chapter addresses the calculation of interest on RECO's deferred costs.

RECO's Interest Calculation

RECO's calculation of interest was presented on RECO's updated Exhibit FPM-8 dated 12/31/02, and subsequently updated in Exhibit RM-8 dated 7/3/03. RECO then presented a final revised version of Exhibit RM-8 which we received on 8/22/03. We note the following with respect to RECO's calculation of interest presented on its Exhibit RM-8:

- It uses monthly balances for BGS, ECA, SBC and restructuring cost deferrals from Exhibits RM-2, RM-3, RM-4 and RM-9, which have in some months been subject to correction and/or revision, as described above in Chapters 2 through 5 of this report.
- It reflects the disallowances ordered by the Board as referenced in the Summary Order dated 7/31/03. The disallowances are with respect to (1) RECO's failure to enter into a multi-year parting contract upon divesting its generating assets, (2) the ensuing hedging costs incurred as a result, (3) RECO's delay in joining PJM, and (4) labor and overhead associated with the transfer of RECO's Eastern Division to PJM and BGS Year 4 auction.
- It applies a net-of-tax calculation to the deferred balances for the period August 2002 through July 2003, by multiplying the deferred balances at 59.15%, reflecting deferred taxes at a combined rate of 40.85%.
- It reflects an annual compounding of interest. The cumulative interest from years 1 through 3 (August 1999 – July 2002), as shown on Exhibit RM-8, pages 1-3, is added to the total deferred balance upon which interest is computed for Year 4 (August 2002 through July 2003), as shown on Exhibit RM-8, page 4.
- For Year 4 (August 2002 through July 2003), the calculation reflects the application of a monthly interest rate of .394%
- For the 12 month period August 2002 through July 2003, RECO's calculation results in cumulative interest of \$6.894 million.

Revised Interest Calculation

The Interest Calculation shown in Volume 2 of this report on Exhibit 6.1 attempts to provide for the standardization of the interest calculation in accordance with guidance provided by Staff. To make this calculation, we used the BGS, ECA, SBC, and deferred restructuring proceeding costs from Chapters 2 through 5 respectively.

We also reflected deferred taxes at 40.85%. We did this by multiplying the monthly Deferred Balance totals by 59.15%.

We used the same interest rate that was reflected by RECO on Exhibit RM-8. This rate was verified to the applicable Board Order or other supporting documentation.

We have also reflected the annual compounding of interest, similar to RECO's calculation on Exhibit RM-8. Annual compounding of interest is consistent with Staff proposed guidance to standardize the interest calculation. The tax deductibility of interest is reflected in the calculation by including the interest in the deferred balance to which the "net-of-tax" factor is applied.

As shown in Exhibit 6.1, this calculation results in cumulative interest of \$6.894 million for the period August 2002 through 2003 on the deferred balances.

Interest Calculation that Reflects Removing the PJM Transfer Labor Disallowance from the specific months and in the specific amounts in which it was recorded by RECO

RECO Exhibit RM-8 and our Exhibit 6.1 remove the entire \$325,000 at 7/31/02. It should be noted that RECO did not record the entire \$325,000 in July 2002, but rather recorded labor and overhead amounts monthly during the period August 2001 through July 2002. By removing the \$325,000 in July 2002, as RECO has done, and as was reflected by RPA witness James Cotton, this essentially would allow RECO to earn interest on the disallowed labor and overhead amounts during the period between when RECO originally recorded the deferrals and July 2002, when RECO removed the \$325,000 from the interest calculation.

Exhibit 6.2 presents an interest calculation which removes the \$325,000 of disallowed labor and overhead costs in the months in which they were recorded by RECO (August 2001 through July 2002). These calculations result in cumulative interest of \$6.882 million. This is a difference of \$12,000 from RECO Exhibit RM-8 and our Exhibit 6.1 for the period August 1, 1999 through July 31, 2003 on the deferred balances.

Appendix I
Synapse Prudence Review
Phase 2: August 2002 – July 2003
Rockland Electric Company

Redacted Version
RECO-Claimed Confidential Information Has Been Redacted

On June 29, 2001, the four New Jersey electric distribution companies (“EDCs”) filed a generic proposal recommending the use of a simultaneous, multi-round descending clock auction as a means of serving Year 4 BGS customer loads and energy requirements. The auction allowed for differences in the prices paid by each utility due to differences in load factor, delivery location, and other variables.

In a Decision and Order dated December 11, 2001, the Board of Public Utilities (“the Board”) found the proposed auction design to be appropriate. In particular, the Board of Public Utilities found that “the EDCs’ proposal, besides being the only fully developed proposal before the Board, will provide the greatest possibility for obtaining Year 4 BGS supplies at minimum cost to customers. It also provides for greater reliance on competitive markets by taking electric supplies out of the exclusive two party/bilateral contract arena and places BGS requirements open to all customers on an equal basis.”¹

The Board further found that its ultimate authority to accept or reject the results of the auction addressed concerns raised by the Ratepayer Advocate regarding the risks for customers in the proposed auction process.²

Second, the Board has the ultimate authority to accept or reject the results of the auction. The Board will direct its Energy Division Director and Chief Economist to observe the BGS auction, along with its consultant CRA. After the auction, the Board will be briefed by Staff and its consultant and receive input from the Auction Manager on the conduct of the auction and its results. At that point the Board would know if any national or industry event occurred which might have skewed the results. It would also know whether any questionable activity occurred during the auction to raise any concerns about the validity of the outcome. The Board retains authority to not certify the auction results and to determine the manner to be used to secure Year 4 supplies. Therefore, the Board’s final

¹ Decision and Order in Docket Nos. EXO01050303, EO01100654, EO01100655, EO01100656, and EO01100657, dated December 11, 2001, at page 19.

² Decision and Order in Docket Nos. EXO01050303, EO01100654, EO01100655, EO01100656, and EO01100657, dated December 11, 2001, at page 20.

certification authority will sufficiently address the RPA comments regarding risk.³

The Year 4 BGS Auction was a statewide descending clock auction, conducted by NERA. The auction was “descending” because bidders reduced the price at which they were willing to provide power with each successive round. As prices fell, so did the portions of BGS load agreed to be provided by the bidders, with the auction ending when the total amount of BGS load met the required load identified by the auction manager. The prices met when the auction closed were those accepted by the utilities. Offers made during the auction were binding, and so there were no post-auction negotiations.

The results of the Year 4 BGS Auction were certified by the Board in an Order dated February 15, 2002. As a result of the Auction, 90 percent of RECO’s load is being served by PPL Energy Plus, LLC and Connectiv Energy Supply, Inc., between August 1, 2002 and July 31, 2003.

A list of prices received by NERA for covering the RECO load has been provided as an attachment to RECO-ADR-S-114. The list identifies prices decreasing from **REDACTED** cents/KWh in the initial round, to **REDACTED** cents/KWh in round 74, the final round.

The auction set the price, and so there were no real evaluations of the bids on behalf of RECO or the Board of Public Utilities prior to the determination of the winning bid.

Synapse has reviewed documents related to the Year 4 BGS Auction and RECO’s participation in that auction. Synapse also has spoken to BPU Staff concerning the auction process.

In conclusion, Synapse has not seen any evidence that unreasonable actions by RECO increased the ultimate price the Company is paying for power for BGS customers during the period August 1, 2002 through July 31, 2003.

³ Decision and Order in Docket Nos. EX001050303, EO01100654, EO01100655, EO01100656, and EO01100657, dated December 11, 2001, at page 20.